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Does Local Government Size Matter? Privatization and Hybrid Systems of Local Service Delivery

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Introduction

The problem of suboptimal local government size stems from historical circumstance (the evolution of local government structure) and the current nature of vertical inter-governmental relations. Small size itself does not have to be a problem if the inter-governmental structure accounts for differences in scale and capacity. Many European countries and the US face a local government sector dominated by many small municipalities. In the US, there are over 39,000 units of multi-purpose local government (Census of Governments, 2007).

The challenge of suboptimal local government size raises two concerns: 1) *capacity* - small size can lead to inadequate financial or managerial capacity, and 2) *fragmentation* can undermine efficiency (due to lack of economies of scale) and prevent coordination necessary for regional economic competitiveness and environmental management. It is these two concerns, capacity and fragmentation, and their implications for rural government viability on the one hand and metropolitan regional coordination on the other hand, that drive scholarly and practical policy interest in the question of suboptimal government size.

The problem of fragmented and suboptimal sized local government is not just a challenge stemming from external forces and structures (Swanstrom, 2006), it is also an issue for internal forces as Imbroscio (2006) argues in his critique of scholars who attempt to “shame the inside game.” To address the challenges of suboptimal government size we need attention to both the inside and the outside game.

On the outside – we need attention to the vertical structure of inter-governmental authority and finance. On the inside – we need attention to capacity and political will. First I will address the context of vertical inter-governmental relations that can ameliorate or exacerbate problems of suboptimal local government size. Then I will turn to my attention to the inside game – what a local government can do on its own to address the challenge. In this second arena I will give special attention to the possibilities of using privatization or hybrid market forms of service delivery to address the challenges of suboptimal local government size. In this review I will focus primarily on the US local government experience and answer the question, “Can privatization and hybrid forms of service delivery help address the problem of suboptimal government size?” I will explore what we know from the empirical evidence on privatization by government size, what explains differences in level of privatization by size, and how these problems can be addressed by market management strategies.

Suboptimal government size can occur at both ends of the spectrum – too small to realize scale economies and too large to enjoy market competition. The solutions require more effective market management: 1) creating more competition by splitting the market, the service or the management, and 2) promoting coordination by combining markets, management and services. The paper begins by addressing the overarching context of the vertical inter-governmental structure of finance and service responsibility that sets the context for a concern over suboptimal government size. Concerns with equity, regional coordination and sustainability drive much of the government size debate, but this paper will show these concerns are not effectively addressed by market management strategies.

Outside Strategies: External Context and Inter-Governmental Structure

The public choice and anti-consolidationist literature argues there are serious advantages to small, fragmented local government (Parks and Oakerson, 1993; Bish, 2001). Politically they afford the opportunity for local difference, diversity and democratic choice. Local governments are considered “laboratories of democracy,” the place where political skills are developed and new service delivery innovations are found. Political fragmentation allows for diversity in service delivery – both in quantity and style of public services. This can lead to governmental innovation (Osborne and Plastrick, 1997). It can also lead to inequity.

The Fiscal Federalists support fragmentation because it promotes fiscal equivalence – balancing service delivery with local government revenue (Oates, 1998). This forces fiscal discipline on local governments and ensures residents get what they pay for and pay for the services they want to receive. The problem of requesting more services and hoping to free ride on their delivery is reduced under such a local government system. Curiously the term ‘territorial equivalence’ is used in the Nordic countries to mean just the opposite – to make equivalent the prospects for local government service even in remote, poor rural areas (Bryden and Warner, 2012). Although the US recognizes that poor governments constrain the development prospects of their residents and this poverty of government services exacerbates territorial inequality (Warner and Pratt, 2005; Johnson, et al., 1995; Stinson, 1968), there is little political will to address the inequity. In the EU by contrast, concern over social inclusion is one of the drivers behind regional and rural development policy (Shortall and Warner, 2011; Powell, Boyne and Ashworth, 2001; Stewart, 2003). Research across the EU, Asia and North America has shown generally that decentralization does not

lead to improved economic growth (Rodriguez-Pose and Bwire, 2004; Nelson and Foster, 1999). Concerns with regional inequality and redistributive equity are important, not just for equity reasons, but also for economic growth.

Australia and New Zealand embarked on major consolidation efforts over the last decade – to mixed effect. While they gained the ability to plan and coordinate service delivery on a larger scale (to address environmental concerns like watersheds, and urban concerns like transportation management), they faced a governance challenge of rebuilding citizen identity and participation in the new, larger units of local government. Recent research has shown that these larger units are not cheaper (Byrnes and Dollery 2002; Dollery and Johnson, 2005), but they are more professional and may be providing services that better coordinate across a larger scale and as such may help position localities to compete more effectively in a global world (Holzer and Fry, 2011; Aulich et al., 2011). During a 2010 national local government conference in Australia, officers from New South Wales and Victoria – two states that conducted major amalgamations in the last decade – indicated that no one wanted to go back to the earlier system. Consolidation has enhanced strategic capacity but still leaves revenue and service delivery challenges (Aulich, et al. 2011, McKinlay 2011a).

In the US, and in much of Europe, consolidation of local government has not been a major policy thrust. In the US political support for localism is very high (Briffault, 2000). As in Australia, local governments are controlled by the states, so there is much diversity in local government authority and structure across the fifty states (Frug and Barron, 2009).

However, local governments in the US have more service responsibility (police, social

welfare, education) than in Australia and most of Europe. In the US there have been few voluntary amalgamations despite much academic research touting the benefits (Orfield, 1997, 2002; Rusk, 1993, 1999). Instead, attention has shifted to functional consolidation in specific service areas. This functional consolidation is both top down and bottom up. The primary example of top down consolidation is found in the Metropolitan Planning Organizations required by the Federal government in order to help manage federal transportation funds (Downs, 1994). The bottom up forms are based on voluntary cooperation either as service specific inter-governmental contracting (which in the US is as common as for profit contracting), or in regional councils of government (Warner, 2011b). However, these service specific forms of coordination are critiqued for being limited in focus, professional in organization, and undemocratic (Frug, 1999). A body of academic research is assessing whether these functional consolidation approaches can achieve the equity and multi-functional coordination that is really needed (Bollens, 1997; Lowe, 2011; Pastor et al., 2009). Regional councils of government may offer more promise as they are both multi-functional and composed of elected officials, not just technocrats (Korsching et al., 1992).

Voluntary approaches are celebrated in the US both theoretically and practically. Public Choice theory is founded on the notion that a competitive market of local government is both efficient and democratic. Charles Tiebout's famous 1956 article celebrates the possibility of efficiency achieved through a competitive, fragmented local government structure. The rise of suburban local governments in the US in the 1950s gave credence to the power of a fragmented local government system based on mobility and choice.

However, reviews of the evidence point to problems with information asymmetry, resource inequality and lack of mobility – especially for the poor (Lowery, 2000). Community choice is driven by more than preference for a specific tax and service combination. Race continues to be a major signaling mechanism (Trout, 2000; Lichter, et al., 2007; Marsh, et al., 2010). Resource and service inequality in a fragmented local government system undermines regional equity across the metropolitan region (Frug, 1999; Frug and Barron, 2008; Pastor et al., 2009; Marsh, et al., 2010). For rural areas, fragmentation and sub-optimal government size leads to problems of “government poverty” and reduced opportunities for residents (Stinson, 1968; Reeder and Jansen, 1995; Warner, 2001; Warner and Pratt, 2005; Dewees, Lobao and Swanson, 2003). Katz (2001) describes this system of differing levels of public services based on residential location as the “price of citizenship” in a fragmented, decentralized system. Although planners promote consolidation as a preferred option (Rusk, 1993; 1999; Orfield, 1997; 2002), support for consolidation in the US remains limited and weak. It is now recognized that attention must be focused on the political structure and preferences in order to achieve support for regional integration (Pastor et al., 2009).

It is possible to promote administrative decentralization to achieve the objectives of democracy and localized input while maintaining fiscal centralization to ensure more equity in the delivery of public goods (Prud homme, 1995). Both neoclassical and Marxists scholars agree that local government will be focused primarily on developmental services over redistributive ones (Schneider, 1989; Peterson, 1981; O'Connor, 1973). And yet

redistributive services are the more important ones to ensure individual mobility and social inclusion. In the US, even education and health expenditures are financed heavily at the local government level. This is part of what makes local government fragmentation such a serious problem for equity and socio economic mobility in the United States.

Inter-governmental aid or centralization of fiscal responsibility can address inequality in resources and reduce the capacity problems of small local governments. Administrative decentralization may be optimal – for the service diversity and innovation noted above, while fiscal decentralization may be undesirable due to inequality of resources across the local government landscape. It is possible to have administrative decentralization without fiscal decentralization. Thus one structural solution to the problem of suboptimal local government size is greater intergovernmental aid or centralization of fiscal responsibility to higher levels of government. Models of spatial inequality among local governments in the US have found centralization of fiscal responsibility upward to the state is more important than state aid in relieving inequality of effort across local governments (Warner, 2001; Warner and Pratt, 2005). In the public education sector, a series of fiscal equalization suits are making their way through the state courts now and forcing a redesign of the educational finance system toward more state centralization of fiscal responsibility (Baicker and Gordon, 2006). Analysis of the results of such fiscal equalization in education expenditure in California, where the experience is the longest, shows greater equality in finance but a leveling down of the public finance of education on a per pupil basis (Silva and Sonstelie, 1995). Peterson (1981) argues, and the empirical research shows, that the upper income tax payer, who can't capture the benefits of extra tax for his own children, is less likely to

support overall tax increases for all. Maintaining broad political support is the challenge of centralization/redistribution schemes, especially in societies like the US where notions of social inclusion have little policy salience.

Although fiscal equivalence is a primary justification for local government fragmentation in the US, states often place limits on the level of local choice regarding taxation and service levels. More than half the states have implemented tax or expenditure limitations, TELs, on local governments. TELs are typically proposed in an effort to keep taxes down and limit the size of government budgets. Their effectiveness in this regard remains unproven (IUCUPE, 1995; Resnick, 2004). Local governments get around the limits by promoting special districts which have their own taxing authority outside the government limit. They also increase reliance on user fees. The general conclusion on TELS is that they do not result in lower expenditures but do result in lower accountability and more fragmentation (due to the proliferation of special districts) –exacerbating the problem of sup-optimal government size in terms of both scale and scope economies.

The US has some of the most fiscally autonomous local governments in the world. Locally raised revenue accounts for about 57% of local government budgets, state aid for close to 40%, and Federal aid for less than 3% (US Census of Government 2002). In addition education expenditures are primarily a local government responsibility in the US, in stark contrast to most other OECD nations where education is a national responsibility.

Thus it is clear that the structure of inter-governmental fiscal and service responsibilities matters to the question of suboptimal local government size. The more competencies and the lower the level of redistributive aid or fiscal centralization of expenditure responsibility, the more important the problem of suboptimal government size becomes. In the US, inequity is an important and persistent result (Brown and Warner, 1991).

Because the quality of local services, especially education, varies so widely across local governments, residents consider their local public services as “private” e.g. just for residents inside their jurisdictional borders. These service quality differences reinforce political boundaries and reduce political support for regional coordination (Frug, 1999). These boundary differences help explain the emergence of independent cities (seceding from their counties in Virginia), or new city formation as rich suburbs incorporate to avoid sharing resources with the larger municipality of which they were formally a part. Far from the elastic city that expands to encompass its suburbs that David Rusk (1999) calls for, we instead see the fragmentation of the metro region to ensure continued inequality in service delivery. Some of these new cities have emerged as contract cities – trying to avoid creating a government apparatus and relying heavily on contracting to provide their service needs (McKinlay 2011a).

The emergence of private interest governments at the neighborhood level reflects a further fragmentation. Most new residential development is in these private interest developments in the US and in much of Europe and the developing world (Nelson, 2005; Glasze, et al., 2006). While these club approaches to service delivery are efficient within the club

(Webster and Lai, 2003), they have problems with long term sustainability and coordination across the city and metropolitan region (Warner, 2011a).

Now I will shift my attention from the ‘outside’ - the structure of local government organization and finance - and in the rest of this chapter I will look at the ‘inside’ - specifically the role contracting can play in helping municipalities address the problem of suboptimal size. However, we need to be cognizant of the broader political and economic context in which contracting, as a strategy should be understood.

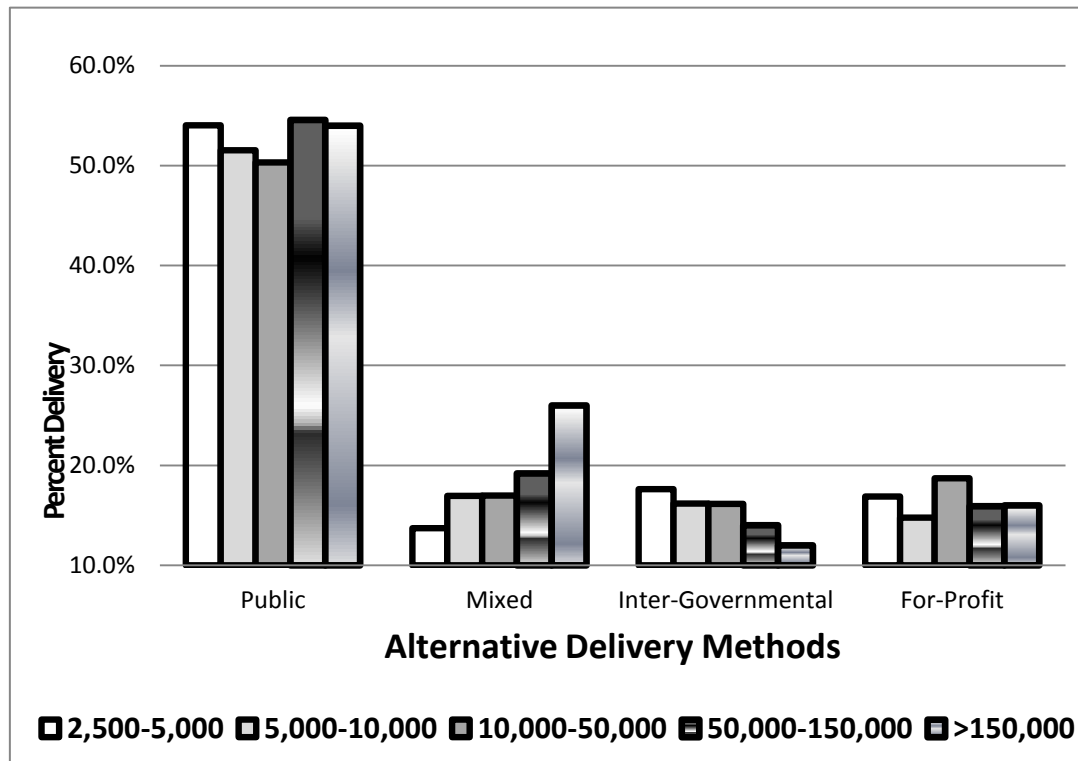
Inside Strategies: Contracting and Hybrid Market Approaches

Contracting is a primary mechanism local governments can use to address suboptimal government size. If their jurisdiction lacks sufficient size to enjoy economies of scale, they can join with other neighboring governments or contract with private providers to deliver services. Contracts to private providers or to other local governments can help municipalities realize scale economies without consolidation. Early studies by the anti-consolidationists pointed to the popularity and efficiency of inter-governmental contracting as the reason why consolidation was unnecessary (Parks and Oakerson, 1993; Bish and Ostrom, 1973). Back office services, such as police dispatch, are especially strong candidates for inter-governmental contracting (they enjoy economies of scale), and this leaves “high touch” services with close contact with residents, such as police patrols, local. Local identity can be as important a factor in service delivery as concerns with efficiency (Warner and Hebdon, 2001) and this is especially important for services which have high resident contact.

In the US, the International City County Management Association has tracked the levels of use of alternative service delivery among local governments. What we find is that inter-governmental contracting and private for profit contracting are the two most common alternatives to direct public provision. Under for profit contracting local governments often face problems maintaining competition and adequate information for benchmarking, thus one hybrid innovation that US local governments pursue is to mix public delivery and contracting for the same service. Analysis of this mixed market delivery shows that it is driven by concerns with cost savings and lack of competition, is more likely to be practiced by local governments with professional managers, and reflects a growing concern over citizen satisfaction with service (Warner and Hefetz, 2008). Local government managers attempt to balance multiple objectives - efficiency, service quality and market management. Mixed market strategies give local government managers more involvement and control in their public service markets.

This paper is primarily concerned with differences in the use of these major alternatives by government size. Figure 1 shows the use of direct public delivery and the major alternatives – for profit contracting, inter-governmental cooperation and mixed public/contracting by population using US local government data recently released by ICMA for 2007.

Figure 1 Service Delivery Trends by Population Size, US Municipalities, 2007



Percents do not sum to 100 because mixed delivery involves multiple categories and non-profit delivery is not included.

International City County Management Association Alternative Service Delivery Survey data 2007: Author Analysis. N=1474. Population categories: 2,500 – 5,000 = 136, 5,001 – 10,000 = 139, 10,001 – 50,000 = 811, 50,001 – 150,000 = 260, greater than 150,001 = 128; US Census of Population, 2000.

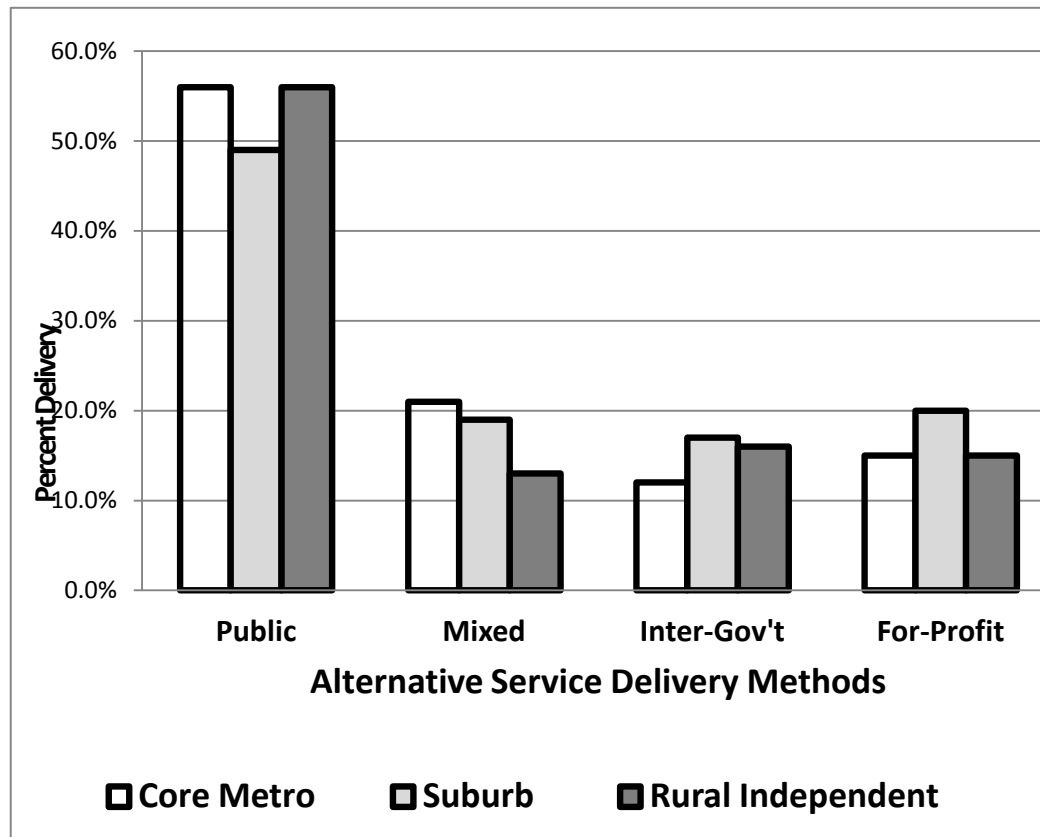
What Figure 1 shows clearly is that direct public delivery is more prevalent at the two ends of the population spectrum. Governments with small population and those with large population have higher levels of direct public provision (a sort of U shaped curve). For profit privatization has the opposite pattern – an inverted U with the highest rates among the mid-sized governments (10,000-50,000 population). Inter-governmental cooperation is more common among the smaller governments and drops as population size increases.

Mixed delivery rises steadily with population size as it requires a large enough scale to split the market into public and contracted components.

These results reflect a general pattern found in the literature on privatization and alternative service delivery in the US (Warner 2006a, 2009; Joassart-Marcelli and Musso, 2005; Warner and Hefetz, 2002a, 2002b, 2003; Nelson, 1997; Hirsch, 1995; Ferris and Graddy, 1994; Kodrzenski, 1994). Smaller communities face less competitive markets of alternative private suppliers and thus rely more heavily on contracting with neighboring governments or direct public provision. Mid-sized communities have higher rates of both privatization and cooperation because they exist in a market of other mid-sized communities which creates more opportunities for both privatization and cooperation. Large communities have lower use of both alternatives because they already enjoy internal economies of scale and the market of similar sized communities is smaller. Similar results have been found in Spain and the Netherlands (Bel and Mur, 2009; Bel and Fageda, 2006, 2010; Bel et al., 2010).

The issue is not just one of population size; it also reflects geographical location. Figure 2 presents the US data by metro status – rural, suburban and urban. We see a similar pattern to Figure 1 above. Public delivery is U shaped with highest reliance on public delivery in rural and metro core places. For profit delivery is an inverted U – highest in suburbs. Cooperation is similar for rural and suburban municipalities but lower among metro core places. Mixed delivery is lowest for rural places and higher for suburb and metro core municipalities.

Figure 2 Service Delivery Trends by Metro Status, US Municipalities, 2007



Percents do not sum to 100 because mixed delivery involves multiple categories and non-profit delivery is not included.

International City County Management Association Alternative Service Delivery Survey data 2007: Author Analysis. N=1474, Metro=262, Suburb=784, Rural=428.

What explains these differences across size and metropolitan status? The answers lie in cost of service delivery, nature of market and capacity of local government. The population and metro status figures reinforce a similar message. Rural and small municipalities are less likely to use privatization and more likely to use cooperation or direct public delivery.

Research has shown that small rural communities have higher costs of service delivery – the costs of sparsity (Reeder and Jansen, 1995; Warner, 2001). They also face more limited markets of alternative private suppliers. Despite a competitive market ethos in the US, real

levels of competition are low in most public service markets. This causes local government managers to spend inordinate amounts of time chasing and nurturing competition (Johnston and Girth, forthcoming). This market management activity comes at the expense of time spent on monitoring and accountability.

Inadequate competition is a problem across the size spectrum but especially serious for small rural governments. In a national survey of levels of competition in local markets for local public services, Warner and Hefetz (2010) found rural municipalities faced on average only 1.1 alternative suppliers for each service as compared to 1.8 for suburban and metro core places. Lack of competition in the private market leads rural communities to rely more heavily on a public market of inter-governmental cooperation. Metro core municipalities, at the other extreme, face the costs of congestion which require a more complex and higher level of service delivery. This limits the number of alternative providers with the capacity to meet metro core needs. The large scale of metro governments also reduces the need to go to market as many services have exhausted any economy of scale advantages at much lower levels of population. Medium sized and suburban communities appear to enjoy dual advantages here – they engage alternative forms of delivery at higher levels than either end of the metro status or population spectrum and they face a more competitive market of alternative supplies.

The pictures presented in Figures 1 and 2 are confirmed in statistical analysis. Regression analyses of for profit contracting and inter-municipal contracting for the 2002 and 2007 period (the most recent data available) are given in Table 1 below. The models show that

for profit privatization is more commonly found among local governments that have larger populations and are suburban. Inter-government contracting, by contrast, is more common among local governments with smaller populations, and among counties and suburbs – places that have the capacity and need to cooperate to gain scale. While for profit contracting is more common among places with higher incomes and lower poverty (more attractive markets), cooperation is income neutral and more likely to be found in communities with higher poverty – suggesting cooperation has some pro-equity effects. For a complete description of model variables and results (see Hefetz et al. 2012).

A similar dual market structure has been found in Spain where small municipalities face competition from smaller, regional firms, and large cities face competition from large national and international firms (Bel and Fageda, 2011). Concentration in public service markets for waste collection is also well documented in the Netherlands (Dijkgraaf and Gradus, 2007; 2008) and in the UK (Davies, 2007). Lack of competition in public service markets leads to less privatization and more inter-governmental contracting (Brown and Potoski, 2003; Levin and Tadelis, 2010; Hefetz and Warner, 2011). Past research has found cooperation to have more pro-equity effects than privatization and differences in use of market alternatives explained more by market attractiveness (wealth, metropolitan status) than by managerial characteristics (Warner and Hefetz, 2002a; 2002b; 2003; Warner, 2006a; 2009; Hefetz, et al., 2012).

Table 1 Regression Results for U.S. Cities and Counties, 2002-2007

Parameter	Inter-Municipal Contracting		For-Profit Contracting	
	2002	2007	2002	2007
Ln(Population)	-.046*	-.064*	.033*	.014*
Suburb Dummy	.194*	.117*	.111*	.138*
County Dummy	.231*	.110*	-.027	-.146*
Total Local Expenditure Per Capita	-.018	.006	-.040*	.006
Ln(Per Capita Income)	.048	-.007	.121*	.120*
Percent Poverty	.005*	.223	-.004*	-.091
Efficiency/Monitoring Index	.166*	-.082*	.296*	.242*
Voice Index	.017	.238*	.213*	.025
Internal Opposition Index	.037	.008	.062*	-.058*
External fiscal pressures	-.090*	-.032	.005	.092*
State or federal mandates	.019	-.003	-.068*	-.004
Change in political climate	-.055	-.149*	.045	-.039
Council Manager Dummy	.076*	.062*	.061*	-.005
Intercept	-1.631*	-.417	-2.608*	-2.442*

* Sig. at $P < 0.05$

Source: Author Analysis drawn from Hefetz, Warner and Vigoda-Gadot, 2012

So what is the problem of suboptimal government size as regards privatization and

alternative forms of service delivery? We see problems on two ends and in the middle.

Both small rural governments and large metro core governments engage market alternatives at a lower rate than their medium sized and suburban counterparts. The solution then points to efforts to enhance size and scale at the lower end by promoting more cooperation among

small rural places so they can more effectively contract with each other and with private market providers. At the metro core end of the spectrum government may be “too large” and we may gain efficiencies by splitting the market or the service so that we can increase market attractiveness. These strategies both involve creating a market – either by cooperating to gain scale or by splitting a service or a market to create competition. But there is also a problem in the middle. Suburban fragmentation does not address the problems of service coordination across a metropolitan region. So from a local government unit perspective, the suboptimal size problem is primarily a rural, small community problem. But from a metropolitan regional perspective, suburban fragmentation impedes a coordinated regional view.

Constructing Markets

The promise of privatization and hybrid strategies is that local governments may be able to overcome the disadvantages of sub optimal size through market management. The analysis above has shown how contracting to private providers or other governments and mixed strategies are used by local governments at differential rates across size, geographic and economic characteristics. What follows below is a more in depth discussion of how local governments can create a market either by combining to gain scale (cooperation) or splitting a service or a market to create competition. Both of these strategies require an explicit local government role in creating and managing markets. A third hybrid strategy is the use of mixed public and private approaches at the level of the market or of the firm. A central theme in all of these market-type alternatives is the need for government capacity to manage markets and promote coordination. Small and rural municipalities use these market

approaches at lower rates as they require scale (to split the market or the service) and management capacity (to combine markets or create mixed strategies) which the smallest municipalities lack. Research has shown it is not ideology, but market attractiveness and limited managerial capacity that explains the lower use of privatization and mixed strategies by small rural governments (Warner and Hefetz 2003, Warner and Hefetz, 2008; Warner 2006a, 2009, Bel and Mur, 2009; Bel and Fageda, 2006; 2007).

Combining Markets to Gain Scale

In the US inter-governmental contracting is highest in social welfare services (child welfare, welfare eligibility, drug programs, job training) and infrastructure services (transit, airports, hazardous waste management). These are services that require coordination across the metropolitan region as labor markets, transit regions and waste disposal (as opposed to collection) all operate at a larger geographic scale than just one municipality. Cooperation in social welfare services reflects the need for technical expertise that can be shared across several municipalities. In Spain, Bel and Mur (2009) find small rural communities cooperate even in waste collection and in doing so are able to deliver a more frequent service at lower cost. Many small Spanish municipalities overcome the problem of small size by cooperating to gain scale and then privatizing (Bel, 2006; Bel and Mur, 2009; Bel and Fageda, 2006). This gives them a scale to be seen in the market and to negotiate better terms with private operators. Despite this, Bel and Fageda (2011) still find that small rural municipalities mostly have contracts with small firms that operate on a local basis, while large firms that operate on a national basis dominate the markets in larger municipalities. They find this structure limits competition and the potential for cost savings. In the

Netherlands, inter-municipal cooperation typically leads to delivery by a public firm and this helps promote competition as public firms bid for contracts outside their own jurisdiction (something not possible in Spain) (Bel et al., 2010).

Spain has some promising approaches with its *mancomunidades* and *comarcas* that are able to engage both public and private service delivery at a larger scale (Fernandez, 2007). Italy has seen the emergence of multi-utilities which combine across services to enjoy economies of scope and multi-government firms (in the same service) to gain scale (Bognetti and Robotti, 2007). In the Netherlands, multi-government public firms are common in refuse collection and help promote competition with private providers (Dijkgraaf and Gradus 2007; 2008). Australia has created a set of regional councils which are given the technical capacity to coordinate across local governments (Holzer and Fry, 2011). Councils of Government in the US reflect a similar effort at cooperation (Korsching et al, 1992). These cooperative approaches allow a small and fragmented local government system to gain the scale necessary to either provide the services publicly or to contract out with private providers and thus gain efficiency and service coordination goals. However, the ability to address the redistribution and equity challenges is less clear as cooperation involves voluntary strategies and governments may be less likely to cooperate with higher need, lower income neighbors (Warner, 2006b; Hefetz et al., 2012).

Strategies which combine services or government units to gain scale are most important in helping rural, small governments compete in the market for public goods. However, even in these circumstances competition is still quite limited. The examples below focus on

splitting the market, the service or the management to increase competition. These strategies require a scale and capacity that the smallest, rural local governments do not have. Thus these strategies are more effective in addressing the challenges at the other end of the spectrum when government may be too large. These splitting strategies can be used for smaller rural governments only if some form of cooperation – to gain scale and promote inter-governmental coordination - precedes the splitting of the market, service or management.

Splitting Markets to Create Competition

For many local government services, economies of scale are exhausted at 20,000 to 25,000 population (Holzer and Fry, 2001). Thus larger municipalities may benefit from splitting their service markets. In the US this is especially common in garbage collection where a city will split its market into districts and contract out some while keeping others public. Such mixed market delivery helps ensure continued competition even after contracts are let and prevents the substitution of a private monopoly for a public one (Warner and Hefetz, 2008). It also enables the public sector to benchmark costs by staying in the business of providing waste collection services. Miranda and Lerner (1994) attribute the lower costs in mixed delivery systems in the US to this ability to benchmark. A final advantage is fail safe control. In the event of contract failure, the public sector retains capacity (equipment, crew and sector knowledge) to provide the service. Mixed market delivery is less common in Europe (Bel and Fageda, 2010) – although Barcelona has employed this technique in both waste collection (Bel and Warner, 2009) and transit services (Albalade, et al., 2012). One key benefit of splitting the market is the ability to maintain competition *in* the market after

contracts are let. Otherwise competition will erode and subsequent calls will find few bidders as the losers left the market and a private monopoly has now been substituted for a public one. For small communities, however, these mixed market strategies are uncommon. Their markets are not large enough to split, and this helps explain the lower levels of competition in small and rural communities.

Splitting the Service

Another approach is to split the service into its component parts and contract out those elements that are more commonly found in the market (back office processes, printing, dispatch), and keep those elements that have high citizen contact public. This is commonly found in police services where the dispatch and criminal investigation functions are often contracted to an inter-governmental level and direct road patrols are kept local. Another common example of splitting the service is in transit where different elements of the service are provided by different parties. Public commuter transit is run by a public agency, para-transit for the elderly and disabled may be run by a private entity or a non-profit (involving volunteer drivers), and van pools for rural outlying areas are run by small private firms (or by cooperatives of riders). All elements of the system are coordinated regarding routes, and there may be joint sharing of garage and maintenance facilities (Warner and Hefetz, 2008). Key to the effectiveness of these mixed delivery systems is joint coordination to manage congestion and ensure public objectives (no cream skimming) are met (Barter, 2008). It is possible for small communities to participate in these mixed service schemes if they are organized as an inter-governmental collaborative, and for transit services, they often are (Warner and Hefetz, 2008; Albalade et al., 2012).

Mixing Public and Private Management at the Level of the Firm

In general European local governments are more likely to mix management and finance between public and private sectors at the level of the firm, rather than mixing public and private delivery at the level of the market as in the US (Warner and Bel, 2008). Public firms and mixed public-private firms enable government to retain economies of scale (without splitting the market) and to retain public sector control (on the Board of Directors) but permit private management and private sector labor relations which promote flexibility. These mixed firms evolved in part from the old State Owned Enterprise sector. But in recent years there have been efforts to instill more internal market discipline through private sector labor and management approaches in a process of corporatization. Berlin used a mixed firm approach to upgrade technology in its urban bus transit sector and to encourage labor shedding and wage reductions after unification (Swarts, 2010). Mixed firms are common in Spain in both water and waste collection (Warner and Bel, 2008).

These hybrid firms are of two general types: public firms which have more flexibility in work force organization and purchasing than public bureaucracy, and mixed public-private firms where the government retains a control stake in the firm, but the firm operates under private commercial law. Public firms, or municipal corporations, are becoming more common in Portugal (Tavares and Camoes, 2007), Spain (Bel and Mur, 2009; Bel and Fageda, 2010), Italy (Bognotti and Robotti, 2007), the Netherlands (Dijkgraaf and Gradus 2007; 2008) and Norway (Sørensen, 2007). By operating on an enterprise basis, they instill market logics inside the firm. In mixed public/private firms, the private partner may be a large firm with a solid position in the market and local government (or a collaborative of

local governments) engage in long term contracts with the private firm as a joint venture (Bel, 2006). Day to day operations are usually conducted by the industrial private partner, but government retains control over strategic decisions. These new forms of public enterprise are emerging to address the need to retain economies of scale by creating monopoly service providers that are flexible and market oriented but responsive to public control. The central theme is the need for public planning and control even while market management and flexibility are pursued (Del Bo and Florio, 2011). Public firms can also be used to achieve economies of scale by contracting with several municipalities as in the Netherlands and Italy, or economies of scope where the multi-utility is a public firm which operates several utilities on an enterprise basis as found in Italy (Bognotti and Robotti, 2007) and New Zealand (McKinlay, 2011b).

I will illustrate an example of the power of a public/private mixed firm by a child care social cooperative I visited in the city of Parma, Italy in 2010. The local government wished to increase the supply of child care and wanted to attract both private finance and a private manager to achieve more flexible labor relations. They created a new mixed firm, Parma Infancia, with control from the local government (which provides subsidies for child care and thus ensures effective consumer demand in the market) and finance from private banks to build new centers. The Director is a banker, and management is by a social cooperative with national scale in elder and child care. The mixed firm has succeeded in building several new centers, expanding a quality child care system to meet community demand, and has done so at costs 30% lower than what the local government could achieve alone. Cost savings are attributed to greater flexibility in labor scheduling.

The advantage of these hybrid organizational approaches to service delivery is that the local government, as a partner in the enterprise, has more control over decisions regarding the service, and easier access to information on the service and on the firm. This reduces the costs of monitoring – a key contract cost - thus reducing overall transaction costs. The goal of such mixed firms is that managers “will give more weight to the objectives of local government and will give less weight to profit maximization.” (Warner and Bel, 2008: 5). In the US, by contrast, where more emphasis is given to creating competition in the market, managers have less time to spend on monitoring and accountability because they spend so much time creating and nurturing competition (Johnston and Girth, forthcoming).

Mixed firms capture the benefits of economies of scale with monopoly provision, but they maintain public control and gain management and labor flexibility. This creates a more stable form of privatization in Europe. In the US, where managers focus their efforts on creating mixed markets with competition between public and private delivery, privatization is both lower and more unstable (Warner and Bel, 2008). Reverse privatization is relatively unknown in Europe and not measured by any national surveys – except Spain which found almost none (Bel, 2006). By contrast, reverse privatization ranges from 12 to 18 percent of service delivery in the US and is comparable to levels of new contracting out (Hefetz and Warner, 2004, 2007). However, smaller rural governments have lower levels of both mixed delivery and contracting back in. Both of these market management approaches require capacity and scale sufficient to play in a market –something small municipalities lack.

Cost Savings and Privatization

Differential rates of privatization are of special concern if there are cost savings with privatization. However, the data on privatization and cost savings does not show clear support for cost savings (Hirsch, 1995; Boyne, 1998; Hodge, 2000; Bel et al., 2010). Water distribution and solid waste collection are the two municipal services with the largest experience with contracting out around the world, and a meta-regression analysis of published studies in these two services does not find support for cost savings under private production (Bel, Fageda and Warner, 2010). Water, as a natural monopoly, does not benefit from splitting the market. Privatization merely results in the substitution of a private monopoly for a public one. Strong regulation of water quality prevents cost savings due to quality reductions. Europe in general has higher levels of privatization. In England and Wales water service has been privatized completely, in France about 52% of the service is private, in Spain about 45% of the service is private, in Germany, Belgium and Finland and Italy between 5 and 20 percent is private (Bel, 2006). The remaining EU-15 countries have almost no privatization (Bel, 2006). France has a long history of private corporations providing water but recently there have been some important reversals such as the high profile re-municipalization of water in Paris where the city decided it can provide water via the public sector more efficiently. Italy, in 2011, overturned a law requiring water privatization. Spain has higher levels of water privatization 42% than in the US 10% (Warner and Bel, 2008). Consistent with the general findings on privatization and government size above, the highest levels of water privatization in Spain are among the municipalities in the 10,000 - 100,000 population range (Bel, 2006).

Solid waste collection has more potential for gains from privatization. Economies of scale are exhausted at about 20,000 population (Stevens, 1978) and this creates potential for gains from privatization even by smaller municipalities. The waste sector is also characterized by technological innovation (trash burn facilities, recycling, new approaches to landfills) and private firms typically capture innovations more quickly than the public sector. For these reasons, privatization levels in solid waste are typically higher than in water. In the US private delivery is found in 47% of municipalities. In Spain it is over half, in Denmark, Sweden and Norway it is over 75%, and in Ireland, the UK, Netherlands and Italy privatization is around 40 percent (Bel, 2006). In Spain privatization rates are lower for municipalities under 10,000 population. In the US privatization of solid waste follows the inverted U shaped pattern – lower for rural (39%), highest for suburbs (57%) and lower for metro core (29%) communities (author analysis of ICMA 2007 data).

Markets alone, through liberalization and privatization, have not delivered lower prices or higher consumer satisfaction in network infrastructure services in the EU (gas, telecom, electricity, water, transit), (Ceriani, Doronzo and Florio, M., 2009; Clifton and Díaz-Fuentes, 2010). Public service markets require management – to ensure quality, to maintain competition, and to ensure broader service coordination. There needs to be a strong principal, ensuring coordination and that public objectives are met. Barter (2008) has shown this critical public coordination role in transit, Clark and Bradshaw (2004) in electricity markets, Hipp and Warner (2008) in job training, and Warner and Gradus (2011) in child care. The problem for small governments, is they lack the capacity to effectively manage markets. Some form of coordination is needed to help small governments gain the scale

sufficient to secure market power to manage their public service markets. This is where inter-municipal cooperation plays such a critical role both as an alternative delivery form when competition is low (Hefetz and Warner, 2011; Levin and Tadelis, 2010) and as a means to gain scale and market power for privatization to work (Bel et al., 2010; Bel and Mur, 2009; Bel and Fageda, 2006).

Conclusion

This paper has explored the question of suboptimal government size and the potential of inside strategies involving privatization and hybrid delivery approaches. We have seen that privatization and hybrid delivery strategies are less common among the smallest rural governments. What is required to effectively engage markets, is to be in a market that attracts competitive suppliers (most common among mid-sized governments and suburbs), or to have the management capacity to build competition, gain scale and manage mixed delivery strategies. Small, rural governments are at a disadvantage in each of these circumstances. Solutions to the problem of suboptimal size require both inside and outside management strategies. This analysis has shown the limits of inside management strategies that focus on privatization and hybrid approaches for the smallest rural governments.

An outside management strategy is also needed. This can involve cooperation among local governments to gain scale and visibility to more effectively participate in the market, or it can involve a restructuring of governmental finance and service delivery competencies to better match the scale at which the service needs to be coordinated. This outside approach requires some level of vertical coordination and hierarchical power. Local governments, on

their own, will limit collaboration to those arenas in which it is clearly in their self interest. Challenges at the metropolitan regional scale require a regional view which is often lost in a fragmented local government system. Voluntary cooperation typically focuses on the services which are easier to address – making it harder to build political support for the services with more inequity across the metropolitan region (Frug, 2002).

Problems with market approaches to address the challenge of sub-optimal government size occur at two ends of the spectrum. The smallest governments are least attractive and least able to play in market systems for public service delivery. This denies many rural areas the opportunity to effectively explore the benefits of service delivery innovation. At the metropolitan regional scale, the problem of suboptimal government size is the problem of fragmentation and the inability to coordinate and finance service delivery across the metropolitan region. This constrains regional economic development (Nelson and Foster, 1999). Solutions to each of these problems lie in collaboration – whether voluntary or forced – to encourage service and resource sharing and promote a regional coordinated view.

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